

**RULE ENFORCEMENT REVIEW OF THE  
COMMODITY EXCHANGE, INC. DIVISION  
OF THE NEW YORK MERCANTILE  
EXCHANGE**



**Division of Market Oversight  
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# **RULE ENFORCEMENT REVIEW OF THE COMMODITY EXCHANGE, INC. DIVISION OF THE NEW YORK MERCANTILE EXCHANGE**

## **I. INTRODUCTION: PURPOSE AND SCOPE**

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the audit trail, trade practice surveillance, and disciplinary programs of the Commodity Exchange, Inc. Division (“COMEX” or “Exchange”) of the New York Mercantile Exchange (“NYMEX”) for compliance with applicable provisions of Section 5(d) of the Commodity Exchange Act (“Act”), as amended by the Commodity Futures Modernization Act of 2000 (“CFMA”), and Part 38 of the Commission’s regulations. The review covers the target period of January 1 through December 31, 2001.<sup>1</sup>

The CFMA, which became effective on December 21, 2000, replaced prescriptive rules with broad, flexible core principles that are applicable to, among other trading facilities, “designated contract markets.”<sup>2</sup> On August 10, 2001, the Commission published final rules, effective October 9, 2001, which implemented the CFMA with respect to trading facilities.<sup>3</sup> The final Part 38 rules include acceptable practices for satisfying the core principles. Specifically,

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<sup>1</sup> Rule enforcement reviews prepared by the Division are intended to present an analysis of an exchange’s overall compliance capabilities for the period under review. Such reviews deal only with programs directly addressed in the review and do not assess all programs. The Division’s analyses, conclusions, and recommendations are based, in large part, upon the Division’s evaluation of a sample of investigation and disciplinary case files, and other exchange documents. This evaluation process, in some instances, identifies specific deficiencies in particular exchange investigations or methods but is not designed to uncover all instances in which an exchange does not address effectively all exchange rule violations or other deficiencies. Neither is such a review intended to go beyond the quality of the exchange’s self-regulatory systems to include direct surveillance of the market, although some direct testing is performed as a measure of quality control.

<sup>2</sup> Section 5(c) of the Act provides that a board of trade, such as COMEX, that was a designated contract market on the date of the enactment of the CFMA shall be considered to be a designated contract market under the Act.

<sup>3</sup> See 66 F.R. 42255

Appendix B to Part 38 provides guidance and acceptable practices concerning the core principles with which a designated contract market must comply to maintain its designation. Although the guidance establishes non-exclusive safe harbors, it does not establish mandatory means of compliance with the core principles.

This review focuses on three core principles that relate to COMEX's audit trail, trade practice surveillance, and disciplinary programs. Core Principle (2) - Compliance with Rules, and Core Principle (12) - Protection of Market Participants, address surveillance, enforcement, and disciplinary procedures used by an exchange to protect market participants from abusive trading practices. Core Principle (10) – Trade Information, relates to maintenance of an audit trail that can be used to assist an exchange in the identification and prosecution of customer and market abuses. Although Appendix B to Part 38 provides acceptable practices for demonstrating compliance with Core Principles 2 and 10, acceptable practices are not described for Core Principle 12.<sup>4</sup> Thus, no safe harbor has been established for that core principle.

For purposes of this review, Division staff interviewed officials and staff from the Exchange's Compliance Department ("Compliance").<sup>5</sup> The Division also reviewed numerous documents used by Compliance in carrying out the Exchange's routine oversight responsibilities. These documents included, among other things, the following:

- computer reports generated by COMEX's automated surveillance systems and other documents used in trade practice surveillance;
- trade practice investigation and disciplinary case logs;

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<sup>4</sup> The Commission has reserved the authority to adopt acceptable practices for compliance with Core Principle 12 at a later date.

<sup>5</sup> A copy of the April 17, 2002 transcript of those interviews can be found in Appendix 1.

- trade practice investigation and disciplinary action files;
- files containing trading card and order ticket recordkeeping reviews;
- compliance manuals and guidelines; and
- minutes of Board of Directors and disciplinary committee meetings held during the target period.

The Division provided the Exchange an opportunity to review and comment on a draft of this report on August 8, 2002. On August 21, 2002, Division staff conducted an exit conference with Exchange officials to discuss the report's findings and recommendations.

## II. SUMMARY OF FINDINGS AND RECOMMENDATIONS

### A. Audit Trail Program: Core Principle (10) – Trade Information

#### Findings

- COMEX generally maintains an adequate audit trail program which provides for the recording and safe storage of complete information on all COMEX trades, including open outcry trades and electronic trades on the ACCESS system, in a manner that enables use of the information to assist in prevention of customer and market abuses and to provide evidence of rule violations.
- The Exchange's audit trail enforcement program includes monthly trading card and bimonthly order ticket reviews, which examine member compliance with recordkeeping requirements and the accuracy of trade data. Order ticket and trading card reviews were thorough, well documented, and completed in a timely manner, and indicated high rates of member compliance with COMEX audit trail recordkeeping requirements.
- COMEX has adequate procedures for reviewing and enforcing compliance with its trading card recordkeeping requirements, including examination of each member's trading cards at least once each year in the course of routine trading card reviews.
- The Exchange's floor order ticket reviews do not provide for sufficient coverage of the Exchange's floor broker population. Under its routine bimonthly schedule, the Exchange reviewed the floor order tickets of only 16 of its approximately 150 floor brokers during the target period, and its method of selecting brokers for review results in many brokers' floor order tickets not being reviewed routinely for an extended period of time.

#### Recommendations

- **COMEX should increase the number of floor brokers reviewed annually in routine floor order ticket reviews, so that each broker's floor order tickets are subject to examination within a reasonable period of time.**

## **B. Trade Practice Surveillance Program: Core Principle (2) – Compliance with Rules, and Core Principle (12) – Protection of Market Participants**

### **Findings**

- COMEX generally maintains an adequate trade practice surveillance program through use of an automated surveillance system, the Trade Surveillance Exception Reporting System (“TSER”), and floor surveillance to monitor and enforce compliance with Exchange rules.
- Exchange compliance staff routinely review TSER exception reports and trade data from the Exchange’s Daily Brokerage Recap report for potential trading violations, and can review and sort all such data online through the Exchange’s Monarch computer system.
- The Exchange closed 44 investigations during the target period, involving possible trading ahead, prearranged trading, and other noncompetitive trading. Seven of these investigations resulted in referral of members to the Exchange’s Business Conduct Committee for disciplinary action, and 16 resulted in issuance of a total of 37 staff warning letters.
- Exchange staff conducted appropriate investigative analyses, and investigations were thorough and well documented. The Exchange also undertook significant and successful efforts to close its older investigations and ensure the timeliness of ongoing investigations.
- The Exchange opened 35 investigations during the target period, of which only three resulted from review of TSER exception reports, the Exchange’s primary surveillance tool for identifying potential trading violations for further investigation. Ten investigations were opened in response to complaints and referrals, and 22 were audit trail reviews. Thus, with the exception of routine recordkeeping reviews, most of the substantive investigations initiated during the target period were dependent on outside sources.
- The Division is concerned that only three investigations were generated internally from TSER exception report review, which should be the source of a preponderance of the Exchange’s investigations. While the low number of internally generated investigations may have resulted in part from the aftermath of September 11, 2001, and from an effort to complete older investigations, effective use of TSER should have generated a larger number of and accounted for a substantial portion of the Exchange’s investigations.

### **Recommendations**

- **COMEX should reexamine its program of TSER exception report review, and make modifications necessary to increase the number of investigations generated.**

## **C. Disciplinary Program: Core Principle (2) – Compliance with Rules**

### **Findings**

- COMEX maintains an adequate disciplinary program, and handles disciplinary proceedings in a timely manner. During the target period, the Exchange issued complaints with reasonable promptness after cases were sent to the BCC, and moved with reasonable promptness after issuance of complaints to conclude the disciplinary process and impose sanctions.
- During the target period, the Exchange assessed \$44,000 in fines against five members and imposed suspensions totaling five weeks for trade practice violations such as noncompetitive trading, prearranged trading, and trading against customer orders. In addition, three members were ordered to pay a total of \$26,931.10 in restitution to customers. Penalties imposed appeared reasonable relative to the conduct being sanctioned, and appear sufficient to deter future similar violations.

### **Recommendations**

Based on the foregoing, the Division has no recommendations at this time with respect to the Exchange's disciplinary program.



### **III. AUDIT TRAIL PROGRAM**

#### **Core Principle (10) – Trade Information:**

**The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market.**

Pursuant to the acceptable practices set forth in Appendix B to Part 38 of the Commission's regulations, an effective contract market audit trail should capture and retain sufficient trade-related information to permit contract market staff to detect trading abuses and to reconstruct transactions within a reasonable period of time. In addition, the contract market must create and maintain an electronic transaction history database that contains information with respect to transactions executed on the designated contract market. An acceptable audit trail also must be able to track a customer order from time of receipt through fill allocation or other disposition. Further, an acceptable audit trail should include original source documents, transaction history, electronic analysis capability and safe storage capability.

Original source documents include unalterable, sequentially identified records on which trade execution information is originally recorded, whether manually or electronically. A transaction history consists of an electronic history of each transaction, including all data that are input into the trade entry or matching system for the transaction to match and clear. These data should include the categories of participants for whom such trades are executed; timing and sequencing data adequate to reconstruct trading; and the identification of each account to which fills are allocated. An electronic analysis capability permits sorting and presenting data included in the transaction history so as to reconstruct trading and to identify possible trading violations, and safe storage capability provides for a method of storing the data included in the transaction

history in a manner that protects the data from unauthorized alteration, accidental erasure or other loss.

#### **A. Exchange Order Flow and Recordkeeping Procedures**

Open outcry orders at COMEX are typically transmitted to the trading floor either by telephone or by electronic transmission over one of the electronic order routing systems used by Exchange members. As required by COMEX Rule 4.81, each telephone order is recorded by the floor broker's clerk on an order ticket which notes the terms of the order and the customer's account identification, and is timestamped using a timestamping device synchronized to the national atomic clock in Colorado. For each electronic order, the electronic order routing system automatically prints the order terms, account identification, and time of the order.<sup>6</sup> If an order is executable when received, the floor broker's clerk transfers it to the floor broker in the trading pit by either verbal communication or hand delivery of the paper order ticket or its printed electronic order routing system equivalent. If an order is not executable when received, the floor broker's clerk may maintain it in his booth until it becomes executable, in most cases including it in an order book listing orders by executability depending on the direction of the market. When an order is executed, the floor broker or his clerk records the fill price in writing on the order ticket. The order ticket is then brought back to the floor clerk's booth, where the clerk contacts the customer to confirm the fill and timestamps the order ticket a second time.

At the time of execution, the floor broker records the trade details on a pre-printed, sequentially-numbered trading card, pursuant to COMEX Rule 4.80. Rule 4.80 requires floor members to record the time of execution to the minute, the floor member's identification, the

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<sup>6</sup> The electronic order routing system used by one member firm for trades in gold, silver, and copper futures and options transmits the order terms, account identification, and time of the order directly to an electronic trading pad used in the ring by floor brokers trading for the firm to track their orders and trades. This proprietary system retains all relevant data in its electronic audit trail.

opposite floor member and clearing member, the customer type indicator (“CTI”) code,<sup>7</sup> and the date, commodity, future or option, delivery month, quantity, and price. In addition, for option orders, members must record the strike price, put or call indicator and expiration month.

COMEX Rule 4.80 also requires that trading card entries be made in non-erasable ink, in chronological order of execution, on sequential lines of the card without skips, and that trades made during the Exchange’s opening or closing periods be so identified. At COMEX, both customer and personal trades are recorded on trading cards, such that all trades are sequenced together.

Floor members must then submit the top ply of each three-ply trading card to the Exchange within 15 minutes of the end of the half-hour bracket period in which the card has been used. When the top ply is deposited at the designated collection point, it is timestamped by Exchange staff, and routed to the floor broker’s primary clearing member (“PCM”), who is responsible for its retention.<sup>8</sup> One of the other plies of the trading card is given to the broker’s clerk, who matches the appropriate order ticket with the trading card and enters the trade information into the Exchange’s On-Line Trade Entry system (“OLTE”) for clearing. The floor member is required to maintain the remaining ply of the trading card.

With respect to an order that is to be entered on ACCESS, NYMEX’s electronic trading system that lists COMEX gold, silver, copper, and aluminum futures for after-hours trading, the order must either be entered within one minute of receipt or a paper order ticket is created and

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<sup>7</sup> A CTI is a numerical code used to identify the source of trades as follows: CTI 1 designates a trade by a member for his or her personal account or an account for which he or she has discretion; CTI 2 is a trade for the trader’s clearing member’s house account; CTI 3 is a trade for another member present on the floor or an account controlled by such other member; and CTI 4 is a trade for any other type of customer.

<sup>8</sup> Each member who executes transactions on the floor must be unconditionally guaranteed by a qualified primary clearing member. Although under COMEX Rule 4.80(g) members have the option of submitting original trading cards to their PCMs for timestamping rather than the Exchange, in practice, the vast majority of members submit their trading cards directly to the Exchange.

timestamped.<sup>9</sup> At present, COMEX ACCESS orders can only be entered by a COMEX member or member's employee who qualifies as an Electronic Trader under Exchange rules.<sup>10</sup> ACCESS automatically records the time of and retains a record of each entry into the system. ACCESS orders, like floor orders, must contain the price, quantity, commodity, contract month, CTI code, clearing member, and account designation.<sup>11</sup> ACCESS automatically matches orders entered into its Matching System, and transmits the trade record electronically to the clearing member firms of the customers on both sides of the trade. ACCESS also automatically records the time of order entry, trade matching, and any modifications made to an order.

All of the trade data that comprise COMEX's audit trail, for both open outcry and ACCESS trades, are contained in the Exchange's Daily Brokerage Recap report ("DBR"). The DBR, along with timing and sequencing information from order tickets and trading cards and the Price Change Register ("PCR" or "time and sales"), allows Exchange staff to adequately reconstruct transactions within a reasonable period of time. These data also permit staff to track an order from time of receipt through fill allocation or other disposition.

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<sup>9</sup> See COMEX Rule 6.22. Orders entered immediately into ACCESS may be entered either into the Matching System or into the Strategy Pad, a database which stores orders, trading strategies, and other information but does not accept, match or report execution of orders. Orders placed in the Strategy Pad are not matched until released by the member into the Matching System.

<sup>10</sup> See COMEX Rules 11.01, 11.03.

<sup>11</sup> See COMEX Rule 6.22.

## **B. Audit Trail Reviews**

To assess compliance with COMEX Rules 4.80 and 4.81, the Exchange conducts routine reviews of trading cards and order tickets.

### **1. Trading Card Reviews**

The Exchange conducts trading card reviews each month, and in the course of those reviews examines every member's trading cards at least once each year. Each monthly review includes approximately one twelfth of the Exchange's members, as selected by Compliance staff from the master Exchange membership list. Members are added to the monthly review whenever the Exchange's Broker vs. Price Change Register Time Comparison Report ("Broker vs. PCR Report")<sup>12</sup> or Broker vs. Broker Report<sup>13</sup> reveal that they may have failed to record trade execution times properly on their trading cards. In addition, members are added if they failed any element of a previous trading card review.<sup>14</sup>

Compliance staff typically examines up to 30 trading cards of each member, drawn from three dates during the month selected by Compliance staff for the review. If a member did not use at least 10 trading cards over the three selected dates, additional cards used by that member on an additional date or dates during the month are also examined. Compliance staff also review the trading cards of a subset of the members included in each trading card review to monitor compliance with the requirement that the original top ply of each trading card be submitted to the

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<sup>12</sup> The Broker vs. PCR Report evaluates trade times by comparing the times recorded by brokers and traders on their trading cards to the time recorded in the Exchange's price change register ("PCR"). COMEX deems a trade execution time to be accurate when it is within one minute on either side of the minute that a corresponding price was reported in the PCR. Based on this comparison for all trades executed during the preceding month, the Broker vs. PCR Report generates a monthly accuracy percentage for every COMEX broker and trader.

<sup>13</sup> The Broker vs. Broker Report compares floor members' reported execution times for several randomly selected days each month to the times reported by floor members for the opposite side of the trade to identify instances where the buy and sell times do not match.

<sup>14</sup> Such members are re-reviewed within two to three months. In a re-review, the member's trading cards are examined for compliance with all trading card requirements, not merely those with respect to which the member previously failed to comply.

Exchange or the member's PCM within 15 minutes after the end of the half-hour bracket in which the card was used. Compliance staff examine approximately 10 trading cards for each selected member and compares the trade times manually recorded on the front of the card with the collection timestamp on the back of the card.<sup>15</sup>

A member's trading cards are reviewed for compliance with eight recordkeeping requirements set forth in Rule 4.80. The requirements are specified in COMEX's Trading Card Review Checklist.<sup>16</sup> Staff will also follow up on other types of possible violations detected during the course of a trading card review. A member with no discrepancies in any of the eight categories is determined to be in "Full Compliance," and a member with a compliance rate of 90 percent or better is noted as being in "Effective Compliance." A member who fails to meet these standards is found to be "Not in Compliance," and is subject to summary disciplinary action. A warning letter is issued for the first finding of "Not in Compliance;" a second infraction within a 12-month period results in a \$100 fine; and a third infraction within 18 months results in a \$500 fine. A fourth infraction within 24 months results in a referral to the Business Conduct Committee ("BCC") for formal disciplinary action.<sup>17</sup>

During the 11 monthly trading card reviews completed during the target period, Compliance staff examined a total of 7,197 trading cards used by 289 members, an average of

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<sup>15</sup> See COMEX Rule 4.80(g). The Exchange explained to the Division that it does not review the trading card collection timeliness of the complete group selected for a trading card review because the process is extremely time consuming and labor intensive. Although Exchange procedures call for the Compliance Department to examine a minimum of five members per month for collection timeliness, in practice, the Compliance Department examines more. In the course of the 11 trading card reviews closed during the target period, a total of 75 members were reviewed for collection timeliness, an average of approximately seven members reviewed each month.

<sup>16</sup> The eight requirements examined include: time of execution to the nearest minute; delineation of opening and closing range times; new trading card use at the start of each bracket period and the post-settlement session; cancellation of unused lines; buys and sales recorded sequentially in chronological order without skipping or sharing lines; timely submission of cards; use of non-erasable ink; and card use in numerical sequence intra-day. A copy of the checklist is attached as Appendix 2.

<sup>17</sup> Disciplinary action is not limited to these summary procedures if Compliance finds substantive violations in addition to trading card violations.

654 trading cards per month. These reviews resulted in 248 Full Compliance letters, 38 Effective Compliance letters, and three warning letters. Two brokers were re-reviewed, with one determined to be in full compliance and one to be in effective compliance. The Division found that the Exchange's trading card reviews were thorough, well-documented, and completed in a timely manner.

The Division believes that COMEX has adequate procedures for reviewing and enforcing compliance with its trading card recordkeeping requirements.

## **2. Order Ticket Reviews**

Compliance conducts order ticket reviews on a bimonthly basis. A supervisor or manager selects one of the approximately 70 broker groups at the Exchange for review, which includes examination of both floor order tickets and branch office order tickets. Broker groups may be selected for inclusion in an order ticket review based on the appearance of order tickets of their members which have been examined during the course of Exchange trade practice investigations.

In a floor order ticket review, Compliance staff examine a minimum of 30 orders from a day (or days) on which the selected broker group had significant trading volume. If Compliance determines that the broker group has sufficient activity on a single day in a single commodity, then orders in that commodity for the selected day are the focus of the review. If a single day's business or the activity in a single commodity is insufficient to provide the minimum required sample, additional trade dates or commodities are selected. A Compliance analyst examines each order ticket for the required account identification information and timestamps.<sup>18</sup> As an adjunct to the review, selected order tickets for filled orders also are matched to the

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<sup>18</sup> The Exchange considers a customer's account number or a unique code traceable to that account an acceptable account identifier. All filled or partially filled orders are required to have entry and exit timestamps, while unfilled or canceled orders are required to have at least an entry timestamp.

corresponding trades on the executing broker's trading cards, which are requested as part of the order ticket review, to determine if the broker's manually recorded execution times on the card are consistent with the order ticket's entry and exit timestamps.

When the floor order ticket review is completed, Compliance conducts a branch office order ticket review. A Compliance analyst examines office orders of one futures commission merchant ("FCM") for whom the selected broker group filled orders.<sup>19</sup> Ten to 15 of the FCM's branch office order tickets are reviewed for the presence of account identification, order number, and a timestamp representing the time of order receipt from the customer. For option orders, the analyst also verifies the presence of a timestamp reflecting the time of order entry. Further, the analyst examines the timestamps on the office order tickets to verify that they are chronologically consistent with trading card times and time and sales prints, and compares the account identifiers on the floor and office order tickets to confirm that they identify the same customer. Similar to trading card reviews, Compliance staff will also follow up on other types of possible violations discovered during the course of floor and branch order ticket reviews.

The Exchange completed six floor order ticket reviews during the target period, examining a total of 216 floor order tickets from a total of 16 floor brokers. The Exchange found that virtually all (215 of the 216 order tickets examined) contained account identification, and 93% (201 of the 216 order tickets) contained required timestamps. As a result of the six floor order ticket reviews, one broker group was issued a Compliance warning letter for failure to properly time stamp floor order tickets. The Exchange completed five branch office order ticket reviews during the target period, examining a total of 50 office order tickets, all of which had

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<sup>19</sup> In those rare cases where the floor order ticket review does not suggest an appropriate FCM for the branch office order ticket review, an FCM not recently reviewed is selected at random.



appropriate account identification, timestamps, and order terms that corresponded to the associated floor order tickets.<sup>20</sup>

The Division's review of the Exchange's order ticket reviews indicates that the reviews were thorough, well documented and completed in a timely manner. However, the Division believes that the Exchange's routine bimonthly floor order ticket review does not provide for sufficient coverage of the Exchange's floor broker population. During the target period, the Exchange reviewed the floor order tickets of a total of only 16 of its approximately 150 floor brokers. Although the Division recognizes that the Exchange also reviews orders that are received during the course of an investigation, the current methodology results in many brokers not being subject to a routine floor order ticket review for an extended period of time. It is important to conduct floor order ticket reviews on a routine basis not only because this may reveal recordkeeping deficiencies, but also, and more importantly, because doing so may identify irregularities on the face of an order that may underlie more substantive violations, such as alteration of an account number to allocate fills to a favored account. Therefore, the Exchange should increase the number of floor brokers it reviews on an annual basis, so that each broker's floor order tickets are routinely subject to examination within a reasonable period of time.

### **C. Safe Storage Capability**

As stated above, COMEX's DBR report contains complete trade information for all trades executed on COMEX, including open outcry trades and electronic trades on the ACCESS system. The DBR is created and maintained on the COMEX IBM mainframe computer, on

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<sup>20</sup> In one branch office order ticket review, Compliance noted that the order tickets were timestamped when the order was transmitted to the trading floor, but that the branch office order tickets were consistently timestamped between one to three minutes later than the corresponding "in" timestamps on the floor order tickets. Compliance concluded that the discrepancy probably resulted from the fact that the timestamp clocks in the branch office may not have been set to the correct time according to the national atomic clock, and issued an appropriate Warning/Advisory letter. In addition, as a result of this review members of a floor group were issued Warning Letters for failing to register as a Broker Association as required under Exchange Rule 6.43(d).

which the OLTE clearing system also resides. Each day, DBR data is backed up on electronic tape, and the tape is taken to the Exchange's off-site backup facility in New Jersey, where it is stored for five years.<sup>21</sup>

In addition to its tape backup system, the Exchange retains microfiche copies of each day's DBR reports and Price Change Registers. Microfiche copies are retained at the main Exchange facility for three years and in off-site storage for five years. The Exchange currently has copies covering trading from 1997 to the present.<sup>22</sup> The Exchange also keeps month-to-month statistics on the trading of each member, derived from DBR data, in a separate log maintained both in hard copy and electronically on its Monarch trade surveillance system.

#### **D. Conclusions and Recommendations**

The Division found that, in general, the Exchange maintains an adequate audit trail program. The Exchange maintains rules and procedures that provide for the recording and safe storage of trade information in a manner that enables Compliance staff to use the information to assist in prevention of customer and market abuses and to provide evidence of any rule violations. The enforcement program consists of monthly trading card and bimonthly order ticket reviews, which examine member compliance with recordkeeping requirements and the accuracy of trade data. The Exchange's order ticket and trading card reviews were thorough, well documented and completed in a timely manner, and examination of these reviews indicated high member rates of compliance with COMEX audit trail recordkeeping requirements.

However, the Division found that the Exchange's floor order ticket reviews do not provide for sufficient coverage of the Exchange's floor broker population. Under its routine

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<sup>21</sup> The backup facility was moved to New Jersey from its previous Manhattan location adjacent to the World Trade Center following September 11, 2001.

<sup>22</sup> The Exchange trade audit department retains hard copies of each day's DBR and Price Change Register until microfiche copies are made, a process which usually takes approximately 10 days.

bimonthly schedule, the Exchange reviewed the floor order tickets of only 16 of its approximately 150 floor brokers during the target period. The Exchange's selection methodology under this schedule results in many brokers' floor order tickets not being reviewed for an extended period of time.

Based on the foregoing, the Division recommends that the Exchange:

- **Increase the number of floor brokers reviewed annually in routine floor order ticket reviews, so that each broker's floor order tickets are subject to examination within a reasonable period of time**

## **IV. TRADE PRACTICE SURVEILLANCE PROGRAM**

### **Core Principle (2) – Compliance with Rules:**

**The board of trade shall monitor and enforce compliance with the rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.**

### **Core Principle (12) – Protection of Market Participants:**

**The board of trade shall establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants.**

Pursuant to Appendix B to Part 38 of the Commission's regulations, a contract market's trade practice surveillance program should have the arrangements, resources, and authority necessary to perform effective rule enforcement. The arrangements and resources attendant to the program should facilitate the direct supervision of the contract market, including analysis of relevant data. The program also should have the authority to discipline, suspend, or terminate the activities of members or market participants pursuant to clear and fair standards.

An acceptable trade practice surveillance program should maintain all data reflecting the details of each transaction executed on the contract market. In this regard, the program should include routine electronic analysis of these data to detect potential trading violations. Additionally, the program should provide for appropriate and thorough investigation of all potential trading violations brought to the contract market's attention. Further, an acceptable trade practice surveillance program should provide for prompt and effective disciplinary action for any violation that is found to have been committed.

#### **A. Compliance Staff**

The Compliance Department, which is responsible for detecting, investigating, and prosecuting trading violations on both the COMEX and NYMEX Divisions, is headed by the

Vice President of Compliance. Including the Vice President, the Trade Practice Surveillance unit consists of 20 staff members.

The Director of Trade Practice Surveillance has overall responsibility for the investigation and prosecution of rule violations, and is assisted in the day-to-day management of the trade practice surveillance program by an Associate Director. One Compliance Counsel and one Associate Counsel support the Trade Practice Surveillance unit. The Compliance Counsel oversees the legal aspects of all trade practice investigations and coordinates all phases of the Exchange's disciplinary proceedings. The Vice President, the Compliance Counsel, the Director and Associate Director ultimately determine whether evidence supports the Compliance Department recommending that an investigation be referred to a disciplinary committee.

In addition to the personnel described above, the staff includes four managers, seven analysts, and one clerk. Additional support staff includes one project coordinator and two secretaries. The Associate Director and managers, who report to the Director, oversee investigations and provide general guidance to the analysts and clerk. They also contribute to the process of determining whether an investigation should be referred to a disciplinary committee. Analysts are responsible for reviewing computerized reports, including the Exchange's trade register, conducting floor surveillance, order ticket and trading card reviews, and investigating potential violations which are indicated by the computerized reports or referred to the Exchange by other sources such as customers, members, or the Commission. The secretaries and clerk perform administrative functions and conduct certain trading card review procedures.

Cases are assigned to analysts based on managers' assessments of analysts' workloads and experience. Analysts rotate to all types of compliance assignments, and work with all of the managers on a rotating basis in order to learn from the particular expertise and experience of

each of the various managers. All Compliance staff assignments include cases from both the NYMEX and COMEX Divisions of the Exchange.

The Division believes that the Exchange's current Compliance staffing levels are sufficient to enable the Exchange to maintain adequate trade practice surveillance and disciplinary programs

#### **B. Automated Trade Practice Surveillance**

The Exchange's core trade practice surveillance program consists of routine reviews of exception reports generated by the Exchange's automated trade practice surveillance system, the Trade Surveillance Exception Reporting System ("TSER"), and manual reviews of the DBR and specialized surveillance reports. Each of these reports and the PCR are available to Compliance Department staff on-line through the Exchange's Monarch computer system, implemented in 1999. Monarch allows analysts to view all pertinent surveillance reports on their desktop computers and to sort the data in spreadsheets. The ability to view and sort data on-line enhances the volume of trade information available for analysts' review. The Monarch system can retrieve data on all trades from October 1999 to the present. As stated earlier, data for previous years is available through hard copies of electronic tape and microfiche backup.

The TSER system generates several daily exception reports designed to isolate suspicious trading activity. TSER reports are generated from data contained in the DBR, with selection parameters adapted for each specific category of potential violation. The reports cover all Exchange trades, whether made via open outcry or the ACCESS electronic trading system. Compliance staff can modify report parameters as necessary. The Exchange uses these reports to identify possible instances of trading ahead, withholding orders, disclosing orders, accommodation trading, prearranged trading, improper cross trading and money passing

schemes. The reports also are used to expand the scope of an investigation when potential violative trading patterns are detected. The principal TSER reports include the following:

- The Trading Ahead Report identifies trades where the executing broker trades for his or her own account, or an account that he or she controls, and the broker's trade is on the same side of the market within five minutes before or after the customer's trade, at a price equal to or better than the price received by the customer.
- The Preferential Trading Report lists instances where a member may be withholding customer orders from the market or disclosing the terms of orders for the benefit of another member. The system searches for any trades where the executing broker executes a customer trade opposite another member's personal trade. It then sorts the opposite member's trades for instances where that member's trades were on the same side of the market as the customer order, within five minutes before or after the customer trade, at a price equal to or better than the price received by the customer.
- The Prearranged Trading Report is designed to detect three potential types of prearranged trading. First, the report identifies possible violations involving a single customer order where the executing broker may have traded indirectly opposite the order through the accommodation of another member. Second, the report identifies possible violations involving two customer orders and an accommodating member. Third, the report identifies possible violations involving three members. In the latter instance, the system selects instances where a broker traded indirectly opposite a customer order through the accommodation of two other members, *i.e.*, where the third member trades for his or her personal account with both brokers, executing a wash trade to accommodate the other brokers.
- The Payback Report is designed to detect members' potential prearranged trading intended to facilitate a money pass between members. It identifies trades between the same executing and opposite brokers who, on the same day, trade at different prices for their personal accounts so that money passes between them.

In addition to these reports, TSER also produces a summary report, Total of Members' Appearances on Exception Reports Over Previous Two Months ("Summary Report"), that identifies the frequency of members' appearances on other reports during the previous two-month period. The Summary Report is reviewed on an as-needed basis.

Each TSER report is generally assigned to the same analyst for daily review, but assignments are rotated periodically so that each analyst becomes proficient in reviewing all of the exception reports. Analysts look for trading patterns indicating possible illegal activity,

taking note of the size of the trades involved in a given pattern and the frequency with which the members involved appear on the exception reports. They also attempt to identify suspicious individual trades, and review exchange records relating to such trades. Analysts record any findings from their review of TSER exception reports on the relevant exception log.<sup>23</sup>

Compliance analysts supplement their review of TSER exception reports by conducting a manual daily review of the DBR. As noted above, the DBR contains complete data for each COMEX trade, including all open outcry and ACCESS trades. The DBR sorts trading data both by executing broker and clearing member, and by executing broker and time of execution.

Analysts also consider information from three specialized, computer-generated reports that detail particular types of trading activity. Compliance staff conduct a weekly review of the Crossed Trades Report to detect possible violations of the Exchange's prohibition against members crossing their customer orders against their personal accounts, and review information from the Broker Unmatched Trade Report and the Correction Audit Trail Report forwarded to them by the Exchange's Trade Audits Department.<sup>24</sup>

### **C. Floor Surveillance**

Exchange trade practice analysts routinely observe trading during the Exchange's opening and closing periods and during the middle of the Exchange's trading day. A bimonthly schedule assigns one analyst per week to spend at least 40 minutes on the floor each day for the COMEX open and at least 40 minutes each day for the COMEX close, and assigns a second

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<sup>23</sup> Samples of TSER review logs are included in Appendix 3.

<sup>24</sup> The Broker Unmatched Trade Report shows all unmatched trades broken down by member for a specific date. The Correction Audit Trail Report displays intra-day changes made to the details of a trade and is sorted by transaction identification number and member. The Trade Audits Department, which is not part of the Exchange's Compliance Department, assists members with trade corrections.



analyst each week to spend at least 20 minutes on the COMEX floor during midday.<sup>25</sup> In addition, all Exchange analysts are required to attend either the NYMEX or COMEX closing period every day.<sup>26</sup> Unscheduled floor surveillance is also conducted whenever needed due to unusual market activity, an anonymous complaint, or an ongoing investigation. Finally, all analysts are encouraged to perform extra surveillance of the trading floor at random times during the trading day, especially during busy periods.

The Exchange uses floor surveillance observations to detect violations; determine the physical location of members relative to other members; determine members' affiliations with other members; document various floor trading practices; identify trading patterns that are unusual for particular members; and deter abuses, such as noncompetitive trading and trading before the open or after the close. All analysts fill out a Weekly Floor Observation Sheet detailing their weekly floor surveillance activities. Analysts who observe possible trading violations while on the floor are required to document their observations immediately in writing.

#### **D. Inquiries and Investigations**

When reviews of exception reports, DBRs and specialized reports, or floor surveillance reveal trading activity which appear to warrant further staff attention but does not yet clearly indicate a potential violation, Compliance staff undertake what the Exchange calls an inquiry. All inquiries are recorded in an inquiry log.<sup>27</sup> Inquiries involve review of additional data available to the exchange in-house, but do not involve a request for trading cards, order tickets,

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<sup>25</sup> Samples of the Compliance Department's floor observation schedules and memoranda with instructions to staff are included in Appendix 4.

<sup>26</sup> Since September 11, 2001, COMEX Division gold, silver, and copper futures and options have been trading on a modified schedule. Effective January 2, 2002, the Exchange resumed the regular opening times for its COMEX Division. However, these markets have continued to trade on an abbreviated schedule with closing times that are one hour earlier than they were prior to September 11, 2001.

<sup>27</sup> A copy of the Exchange's inquiry log can be found in Appendix 5.

or other documentation available only through a request to a member or PCM. Additional in-house data reviewed may include DBR data for previous or subsequent dates, further exception reports, or additional floor surveillance. An inquiry is not a prerequisite for an investigation, and Compliance staff can open an investigation directly following exception report review if they believe one is warranted.

If Compliance staff conclude after conducting an inquiry that there is insufficient reason to proceed to a formal investigation, they prepare a short inquiry memorandum noting the reasons for and the results of the inquiry. An inquiry file is then created, and the memorandum is retained in the file along with copies of any documents reviewed in the course of the inquiry. If staff conclude that a formal investigation is warranted, the inquiry is closed and an investigation is opened.<sup>28</sup>

When an investigation is opened, whether resulting from an inquiry, as described above, or directly from routine surveillance or external sources, an investigation number and an analyst and supervisor are assigned, and the matter is entered into a separate investigation log. For each investigation, the log records the date the investigation was opened, the member(s) being investigated, the nature of the investigation, and the identity of the assigned analyst.<sup>29</sup> At the start of an investigation, Compliance staff request trading cards, order tickets, and other underlying documentation from the members and PCMs involved by sending a form letter, which is hand delivered, mailed, or faxed, or accepted in the Compliance office by the addressee or his or her designee. In either instance, the recipient signs a copy of the letter to acknowledge

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<sup>28</sup> Compliance completed 18 of 19 inquiries opened during the target period, none of which evolved into an investigation. The 19 inquiries included three generated from TSER reports, three from DBR review, and seven from review of out trade and trade correction reports. In addition, one inquiry resulted from floor surveillance and five were opened in connection with member complaints. One inquiry resulted in the issuance of a staff warning letter to a member for improper execution of discretionary orders.

<sup>29</sup> A copy of the investigation log can be found in Appendix 6.

receipt. A signed, timestamped copy is kept in the investigation file. When the requested documents are received, the analyst reviews them along with other records, including relevant TSER and PCR reports and DBR data, and conducts interviews of relevant persons. While the initial direction and scope of an investigation may be determined by the alleged violation, investigations are expanded when other potential violations become evident as the investigation progresses.

Once the analyst conducting an investigation reaches a conclusion as to whether there is sufficient evidence to support disciplinary charges, the analyst and his or her manager or supervisor meet with the Director or Associate Director of Compliance, either of whom has authority to decide whether to close the investigation without further action or to refer the matter to the BCC with a recommendation that charges be brought.<sup>30</sup> If the Director or Associate Director of Compliance decide that the investigation should be closed without further action, Compliance assigns the date of the meeting as the date the investigation is closed. The analyst prepares a close-out memorandum summarizing the investigation and giving the rationale for the decision not to proceed with disciplinary action. It is Compliance Department policy that closeout memoranda be completed within three weeks of the decision to close the investigation. After the memorandum is signed by the analyst and supervisor, and approved and signed by either the Director or Associate Director of Compliance, it is retained in the file. If a staff warning letter is appropriate in the circumstances, it is issued at the time the close-out memorandum is approved. The subject(s) of the investigation, and any complainant involved, are notified of the investigation's close, in person or in writing, within 48 hours of completion of the closeout memorandum. The Division reviewed the close-out memoranda included in all

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<sup>30</sup> In those relatively rare cases where Compliance staff find the decision on whether to recommend disciplinary action to be a close call, the issue is considered in a meeting of the Vice President for Compliance, Compliance Counsel, and the Director and Associate Director of Compliance, attended by the analyst and manager if needed.

target period investigation files, and found that they contained appropriate information and decision rationales.

If the Director or Associate Director of Compliance determine that disciplinary action is warranted, the analyst prepares a more detailed investigation report under the supervision of his or her manager, describing the steps taken in the investigation, the facts developed, the analyses conducted, and the staff's conclusions and recommendations. While preparing the report, the analyst or manager may consult with the Director or Associate Director, the Compliance Counsel, or the Vice President of Compliance concerning significant issues involved in the matter. After the report is signed by the analyst and his or her manager, and approved and signed by either the Director or Associate Director and by Compliance Counsel, it receives final review and approval by the Vice President of Compliance. For cases referred to the BCC, the date of the Vice President's approval is the date the investigation is considered closed. During the target period, the Exchange undertook efforts to expedite preparation of investigation reports, without reducing the level of detail requested by the BCC, through increased use of document scanning and more concise descriptions of the trading activity at issue.

#### **E. Adequacy of Investigations**

During the target period, Compliance staff opened 35 investigations. Three investigations resulted from review of TSER exception reports, two involving possible prearranged trading and one involving possible wash trades.<sup>31</sup> Ten investigations were opened in response to complaints and referrals, including four member complaints, two customer complaints, one anonymous complaint, one floor committee referral, one referral from the National Futures Association, and one from the Exchange's legal department. The remaining

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<sup>31</sup> The prearranged trading investigations were No. 06-206 and No. 06-240; the wash trading investigation was No. 06-222. Investigation No. 06-206 was closed during the target period without disciplinary action. Investigations No. 06-240 and 06-222 remained open at the conclusion of the target period.

investigations on the Exchange's log were the 11 trading card reviews, six floor order ticket reviews, and five branch office order ticket reviews conducted during the target period.

Compliance also closed 44 investigations during the target period. These involved possible trading ahead, prearranged trading, and other noncompetitive trading, as well as customer, member and anonymous complaints. Seven of the 44 investigations resulted in the referral of members to the BCC for disciplinary action.<sup>32</sup> Sixteen of the 44 investigations resulted in the issuance of a total of 37 staff warning letters, covering offenses ranging from violation of Exchange rules prohibiting prearranged trading and improper cross trades to failure by members to provide records, properly timestamp orders, or register with the Exchange as broker associations.

The Division reviewed all 44 investigations closed during the target period, including two which had been referred to the Exchange by the Division.<sup>33</sup> The Division found that Exchange staff conducted appropriate investigative analyses and that investigations were thorough and well documented.<sup>34</sup> For example, in Investigation No. 06-065, Compliance followed up on a lead provided by the trading ahead TSER report. Compliance reviewed all relevant trading documents, reconstructed the trading activity involved, and interviewed all relevant witnesses. Although no trading ahead was found, the investigation resulted in issuance of a complaint alleging violations including crossing of orders, misallocation of trades, creation of fictitious

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<sup>32</sup> The Exchange's disciplinary program is discussed below at pages 32-40.

<sup>33</sup> One of the Division's referrals, Investigation No. 06-199, resulted in the issuance of staff warning letters to three members for violation of Exchange Rule 4.24(d), "Prohibited Cross Trades." The other Division referral, Investigation No. 02-149, resulted from a customer complaint regarding a bad fill price he received on one order and an unfilled order placed in the gold futures market on trade date September 28, 1999. The investigation was expanded to include other alleged trading abuses, and the matter has been referred to the BCC for disciplinary action.

<sup>34</sup> Each of the investigation files contained relevant documentation, including copies of trading cards, order tickets, computerized exception reports, DBRs, PCRs, and correspondence. In addition, interviews of subject members were tape recorded and the tapes were included in investigation files. Where interview tapes were transcribed, transcript copies were also included in investigation files.

order tickets, improperly recorded trades, and misconduct.<sup>35</sup> Another example is Investigation No. 06-158. In this investigation, Compliance staff combined information from TSER reports with extensive document review and appropriate interviews. The investigation resulted in a complaint against two members for noncompetitive and prearranged trading, crossing of orders, improper recording of trade information, and prohibited dual trading. As of the end of the target period, the Exchange was considering offers of settlement submitted by both members calling for imposition of monetary penalties, suspension of trading privileges, and cease and desist orders. A final example is Investigation 06-121, in which Compliance staff reviewed TSER prearranged trading reports to follow up on possible violations detected in the course of a prior investigation. The investigation resulted in a complaint charging two members with noncompetitive and prearranged trading, improper cross trading, prohibited dual trading, and fraud or bad faith.<sup>36</sup>

The Division is concerned, however, that only three investigations were generated internally from the Exchange's TSER exception reports. Since TSER is COMEX's principal tool for internally identifying possible trading violations, these reports would be expected to be the source for a preponderance of the investigations generated by Compliance.<sup>37</sup> With the exception of routine recordkeeping reviews, however, most of the Exchange's investigations initiated during the target period were dependent on outside sources. While the Division recognizes that the low number of investigations generated by Compliance may have resulted in part from the aftermath of the events of September 11, 2001, and in part from Compliance's decision to focus on completing older investigations, the Division nonetheless believes that

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<sup>35</sup> Subsequent to the target period, the member was fined \$4,000 and suspended for one week.

<sup>36</sup> Disciplinary actions are pending in Cases 06-121 and 06-158.

<sup>37</sup> In comparison, during the one year target period covered in the Division's last Rule Enforcement Review of the Exchange, conducted in 1999, the Exchange opened 46 investigations generated by the Compliance Department. Thirty-six of those 46 investigations, or 78 percent, resulted from Compliance review of TSER exception reports.

effective use of TSER should have generated a larger number of investigations and accounted for a substantial portion of the Exchange's investigations. Therefore, the Exchange should reexamine its program of TSER exception report review, and make modifications necessary to increase the number of investigations generated.

#### **F. Timeliness of Investigations**

The Exchange monitors the timeliness of investigations through monthly preparation and supervisory use of the Exchange's Open Case List, which includes, among other information, the age of the investigations measured by days open.<sup>38</sup> Compliance staff log each investigation when it is opened, and Compliance administrative staff regularly transfer investigation information from the log book to the Open Case List, which is maintained in an Excel spreadsheet. This spreadsheet is sorted by days open to highlight older investigations and track investigation initiation. At the end of the target period, the Exchange instituted additional procedures to ensure the timeliness of ongoing investigations. Weekly meetings are now held between the Associate Director of Compliance and the Compliance managers to review case loads and establish deadlines for investigation progress. The Associate Director holds follow-up meetings with the managers concerning these deadlines four weeks after they are established. According to Compliance staff, these procedures have further improved the Exchange's overall investigation timeliness.

The Division found that the Exchange's investigations were generally completed in a timely manner. Of the 44 investigations closed during the target period, 73 percent (32 investigations) were completed within one year, including 60 percent (26 investigations) completed in four months or less. Twenty-seven percent (12 investigations) of the 44 closed

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<sup>38</sup> Samples of the Open Case List are included in Appendix 7.

investigations had been open for more than one year, including seven that were open for more than two years.

According to the Exchange, three factors were generally responsible for the length of time taken in the 12 longest investigations. First, many of these investigations were very fact intensive and required numerous reconstructions and requests for and review of additional trading documents. Second, during a number of these investigations Compliance experienced staff turnover and reductions which resulted in reassignment of some of the investigations to one, two, or in some cases three different analysts. Third, significant delays resulted from factors outside normal Exchange operations or Exchange control, including the need for ongoing response to investigations arising from the trading of gold options on September 28, 1999, and the impact of the events of September 11, 2001. The Division believes that, in general, these factors justify the length of time required for completion of the 12 older investigations.

It is also noteworthy that during the target period the Exchange undertook significant and successful efforts to close the older investigations. Eight of the 12 older investigations were closed during the target period, and three more were closed within one month after the target period. Of these 12 older investigations, five (including three of the seven which had been open for more than two years) were referred to the BCC for disciplinary action, while three resulted in issuance of Compliance staff warning letters and three were closed with no action taken. One case related to gold options trading on September 28, 1999 remained open after the target period. Of the total of 26 investigations open at the beginning of the target period, 22 were closed during the period, including a total of six that were referred to the BCC.



## G. Conclusions and Recommendations

The Division found that, in general, the Exchange maintains an adequate trade practice surveillance program for monitoring and enforcing compliance with Exchange rules. Compliance staff dedicated to trade practice surveillance are led by an experienced management team and successfully develop timely investigations and prosecute disciplinary actions. All data concerning each COMEX trade are available to Compliance staff through the Exchange's MONARCH computer system, and Compliance staff conduct routine electronic analysis of these data to detect potential trading violations. Investigations were thorough, well analyzed, and adequately supported by documentation, and were generally completed in a timely manner. During the target period, the Exchange undertook significant and successful efforts to close its older investigations and further ensure the timeliness of ongoing investigations.

The Division also found, however, that over the course of the year-long target period, only three investigations were generated from the Exchange's TSER exception reports. Since TSER is COMEX's principal tool for independently identifying possible trading violations, the reports would be expected to be the source for a preponderance of the investigations generated by Compliance and to lead to a larger number of investigations. With the exception of routine recordkeeping reviews, most of the Exchange's investigations during the target period were dependent on outside sources.

Based on the foregoing, the Division recommends that the Exchange:

- **Reexamine its program of TSER exception report review, and make modifications necessary to increase the number of investigations generated.**

## V. DISCIPLINARY PROGRAM

As stated earlier, Core Principle 2 requires, among other things, that an Exchange have the authority to discipline, suspend, or terminate the activities of members or market participants pursuant to clear and fair standards. In this regard, an acceptable program should provide for prompt and effective disciplinary action for any violation that is found to have been committed.

### A. Disciplinary Committees

The COMEX and NYMEX divisions of the Exchange are subject to the same disciplinary rules, and to the jurisdiction of the same disciplinary committees, which are divided into separate COMEX and NYMEX panels. Unless otherwise noted, references to panels of disciplinary committees in this report refer to the appropriate COMEX panel.

COMEX has three principal disciplinary committees: the BCC, the Adjudication Committee, and the Appeals Committee. In addition, the Floor Committee has authority to enforce recordkeeping, clerk registration, decorum, and similar administrative rules through imposition of summary fines as provided in the Exchange's summary fine schedules.<sup>39</sup>

The BCC is responsible for determining whether a member should be prosecuted for violations of Exchange or Commission rules, and is authorized to enter into settlement agreements in conjunction with initiation of disciplinary proceedings. The COMEX panel of the BCC consists of a Chairman, who is a NYMEX Division member, a Vice Chairman who is a COMEX member, nine regular committee members, and four alternates.<sup>40</sup>

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<sup>39</sup> See Exchange Rules 8.21, 8.22.

<sup>40</sup> Disciplinary Rule 3.13 requires that the COMEX Panel of the BCC be comprised of 70 percent COMEX members and 30 percent NYMEX members. The rule further requires that the nine members include at least one person who is neither an Exchange member nor a member's employee. The remaining Panel members are to include floor brokers, locals, traders, and FCMs.

The Adjudication Committee (“AC”), through its Hearing Panels, conducts hearings to determine whether rule violations have occurred, and levies sanctions for any violations found to have been committed. A Hearing Panel can also enter into settlement agreements with charged members. The AC is divided into two COMEX and two NYMEX Hearing Panels, each consisting of 10 members and designated alternates.<sup>41</sup>

Appeals from Hearing Panel decisions are heard by the Appeals Committee, whose members are selected by its Chairman. In the event of an appeal, the Chairman appoints an Appeals Panel consisting of three committee members, one of whom must be a COMEX member.<sup>42</sup>

All members selected to serve on an Exchange disciplinary committee must be approved by the Board of Directors (“Board”). They may not sit with respect to a matter under consideration if they have any direct financial, personal, or other interest in it. Any person who participated in any prior stage of the disciplinary process is not eligible to serve in a higher decisional capacity for the same proceeding. In addition, a person is prohibited from serving on any disciplinary body if within the prior three years he or she has been found to have committed a disqualifying disciplinary offense or entered into a settlement agreement finding that he or she committed such an offense.<sup>43</sup>

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<sup>41</sup> Disciplinary Rule 3.10 requires that each COMEX Hearing Panel be comprised of 70 percent COMEX members and 30 percent NYMEX members. The rule further requires that each Hearing Panel include at least one person who is neither an Exchange member nor a member’s employee. The remaining Panel members are to include floor brokers, locals, traders, and FCMs.

<sup>42</sup> See Disciplinary Rule 8.16.

<sup>43</sup> Disciplinary Rule 3.03 defines disqualifying disciplinary offenses generally to include any violation of the Act or Commission regulations, and any violation of a self-regulatory organization’s rules, except those rules related to decorum or attire, financial requirements, or reporting or recordkeeping, providing that the violations of the excepted rules did not result in fines aggregating \$5,000 or more within a single calendar year.

## **B. Disciplinary Procedures**

If the Compliance Department determines that there is a reasonable basis to believe that a member has violated an Exchange rule, it forwards to the BCC an investigation report prepared as noted above. The investigation report includes the reasons for initiation of the investigation, the relevant facts, and the Compliance Department's conclusions and recommendations. In addition, Compliance staff inform BCC members orally of the relevant disciplinary history of the member(s) involved in the investigation report.

The Compliance Department may negotiate a settlement agreement prior to submitting an investigation report to the BCC, subject to BCC approval of the agreement.<sup>44</sup> Such settlement agreements reached prior to submission of a matter to the BCC may provide for any combination of the following sanctions: a cease and desist order, a censure, or a fine not exceeding \$5,000 for each rule violation alleged.

Once a matter has been submitted to the BCC for disciplinary action, the BCC may consider settlement offers from the charged member(s) and may enter into settlement agreements which may provide for any combination of the following sanctions: a cease and desist order; a censure; an order directing restitution to any injured person; a fine not to exceed \$25,000 for each Rule violation alleged; or an expulsion or suspension from all or some rights and privileges of membership, the ability to hold a permit, Electronic Trading Privileges, employment on the Exchange Floor, or employment for the purpose of entering orders on ACCESS, for a period not to exceed three (3) months for each Rule violation alleged.<sup>45</sup>

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<sup>44</sup> See Disciplinary Rule 8.03. Any settlement agreement approved or entered into by the BCC is subject to Board approval.

<sup>45</sup> *Id.* Once a matter has been submitted to the BCC, the BCC cannot accept or enter into a settlement agreement unless it is in writing and the Compliance Department has been allowed to respond to the proposed agreement in writing.

When an investigation report is submitted to the BCC, a copy is served on the Exchange member who is the subject of the report. The member then has five days to submit a written statement and supporting documentation to the BCC for its consideration.<sup>46</sup> The COMEX Panel of the BCC then considers the matter at its next bimonthly meeting following expiration of this five day period. Members against whom Compliance has recommended charges may appear and make oral presentations to the COMEX Panel of the BCC, but may only address matters raised in their written responses to the investigation report.<sup>47</sup> If the BCC determines that a reasonable basis exists for finding that a rule violation has occurred, it may return the matter to Compliance for further investigation, issue a warning letter, or direct Compliance to issue a complaint.<sup>48</sup>

When Compliance issues a complaint, it is delivered to the respondent member, filed with the Exchange's Hearing Registrar, and forwarded to the Adjudication Committee, along with any written response or request for hearing from the respondent and any written reply from Compliance.<sup>49</sup> The Chairman of the Adjudication Committee assigns the case to one of the two COMEX Hearing Panels for hearing and decision. If a settlement offer is made at this stage, it is considered by the other COMEX Hearing Panel, and if approved is subject to Board approval. The Hearing Panel may agree to the same sanctions which may be imposed by the BCC, as noted above, except that fines may be levied up to \$250,000 per violation, and there is no limit on the length of a suspension.

If the respondent admits or fails to deny any rule violation charged in the complaint, the Hearing Panel must impose a penalty for each violation, and notify the respondent within 45

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<sup>46</sup> See Disciplinary Rule 8.02.

<sup>47</sup> See Disciplinary Rule 8.02(D).

<sup>48</sup> See Disciplinary Rule 8.02(E). The BCC will also direct Compliance to notify the subject member of its findings.

<sup>49</sup> Under Disciplinary Rule 8.05, the respondent may file a written answer to the complaint and request a hearing within 10 business days after service of the complaint. Under Disciplinary Rule 8.04(D), failure to request a hearing within the 10-day period constitutes a waiver of a right to a hearing.

days after receipt of the admission or failure to deny. If the respondent has submitted an answer denying the charges, and has waived a hearing, the Hearing Panel must make its decision based on the documents filed by Compliance and the respondent, and render a written decision in the same manner as if a hearing had been conducted.<sup>50</sup>

If a disciplinary matter proceeds to a hearing, the Hearing Panel must render a written decision within 45 days after the close of the hearing or the last day on which any post-hearing memoranda were required to be filed. If the respondent is found not to have committed any violation, the written decision must include a summary of the charges and the answer, a summary of the evidence produced at the hearing, and a statement of the findings and conclusions of the Hearing Panel with respect to each charge. If the respondent is found to have committed a violation, the written decision also must include an order stating the penalties imposed and their effective date. The sanctions that the Hearing Panel may impose are the same as those which may be included in a Hearing Panel settlement agreement as discussed above. Unless appealed within 10 days, the Hearing Panel's decision is the final decision of the Exchange, and is effective 15 days after delivery to the respondent and the Commission.<sup>51</sup>

In the event of an appeal, the Appeals Committee Chairman appoints an Appeals Panel to hear and decide the appeal. The Appeals Panel may require the parties to make an oral presentation or may decide the appeal on the basis of the written submissions of the parties and the record of the Adjudicative Committee proceedings. The Appeals Panel may affirm, reverse, or modify the Hearing Panel's decision, but may not set aside the Hearing Panel's findings of rule violations if those findings are supported by the record. The Appeals Panel's written decision must include, among other things, a statement of findings and conclusions regarding

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<sup>50</sup> See Disciplinary Rule 8.11.

<sup>51</sup> See Disciplinary Rules 8.12(A) and 8.13.

each charge or penalty reviewed. The Appeals Panel's decision constitutes the final decision of the Exchange, and takes effect 15 days after delivery to the respondent and the Commission.<sup>52</sup>

### **C. Timeliness of Disciplinary Procedures**

To assess the timeliness of Exchange disciplinary procedures, the Division reviewed the COMEX Trade Practice Investigation Log and Final Disciplinary Actions Log for the target period, the minutes of Exchange disciplinary committees, and all related Exchange disciplinary files.<sup>53</sup>

During the target period, Compliance forwarded seven cases to the BCC for disciplinary action. The Division found that the Exchange generally issued complaints with reasonable promptness after cases were sent to the BCC. As noted above, the COMEX Panel of the BCC meets on a bimonthly basis, in alternation with the NYMEX Panel, although special meetings are called when necessary. Complaints were issued within two months after Cases 04-207 and 03-204 were sent to the BCC. In Cases 06-110, 06-121, and 02-149, complaints were delayed by the events of September 11, 2001, but were issued within three to five months. In Case 06-065, a complaint was issued six months after the matter was sent to the BCC, due to a normal postponement request by the respondent member for the purpose of retaining counsel and making a settlement offer. Final disciplinary action in that case included payment of a \$4,000 fine and a one week suspension. In Case 06-158, the BCC voted to issue a complaint one month after receiving the case, but issuance of the complaint was delayed for six months due to the events of September 11, 2001, and the complex nature of the 22 separate counts involved. The case is currently scheduled for an adjudicatory hearing, and the Exchange is considering a settlement offer from the respondent member.

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<sup>52</sup> See Disciplinary Rules 8.16, 8.17, 8.18, 8.19, and 8.20.

<sup>53</sup> A copy of the COMEX Final Disciplinary Actions Log is attached as Appendix 8.

The Division also found that the Exchange moved with reasonable promptness after issuance of complaints to conclude the disciplinary process and impose sanctions. During the target period, the Exchange brought five disciplinary cases to a final conclusion, including four cases forwarded to the BCC prior to the beginning of the target period and once case sent to the BCC during the target period.<sup>54</sup> In three of these cases, disciplinary action including imposition of sanctions was concluded within three to nine months after complaints were issued.<sup>55</sup> The remaining two cases were concluded by issuance of BCC warning letters one to five months after the cases were sent to the BCC.<sup>56</sup>

#### **D. Sanctions Imposed**

To assess the penalties imposed by the Exchange, the Division reviewed the Exchange Final Disciplinary Actions Log and Exchange disciplinary committee minutes, Regulation 9.11 disciplinary action notices reflecting disciplinary actions taken during the target period, and all related Exchange disciplinary files. As noted above, during the target period, the Exchange brought five disciplinary cases to a final conclusion. In these cases, the Exchange imposed fines totaling \$44,000 against five members for violations of trade practice, recordkeeping, financial, and conduct rules. In addition, the Exchange suspended two members for a total of five weeks, issued three BCC warning letters to three members and one member firm, and ordered three members to pay restitution totaling \$26,931.10 to disadvantaged customers.<sup>57</sup>

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<sup>54</sup> The four cases sent to the BCC prior to the beginning of the target period and concluded during the target period were Cases 06-045, 04-176, F-02, and 06-174. Case 04-207 was both sent to the BCC and brought to a final conclusion during the target period.

<sup>55</sup> These cases included Cases 06-045, F-02, and 04-207.

<sup>56</sup> Case 04-176 was concluded with a BCC warning letter to a floor broker for failure to properly report cross trades, and Case 06-174 was concluded with a warning letter to a member firm for failure to properly timestamp branch office order tickets.

<sup>57</sup> Restitution to disadvantaged customers was ordered in Case No. F-02 in the amount of \$23,781.10, and was ordered in case No. 06-045 in the amount of \$3,150.



Case 06-045 involved five Exchange members. One respondent was fined \$12,500, ordered to pay \$3,150 in customer restitution, and suspended for three weeks for noncompetitive trading, improper cross trading, prearranged trading, prohibited dual trading, and improper recordation of trades. A second respondent was fined \$3,000 and suspended for two weeks for noncompetitive trading, prearranged trading and improper recordation of trades, while a third respondent was fined \$6,000 (including \$2,000 in suspended fines) for noncompetitive and prearranged trading. One remaining respondent received a BCC warning letter and the other received a staff warning letter. In Case F-02, the respondent member was fined \$17,500 and ordered to pay customer restitution of \$23,781.10 for violation of Exchange rules regarding customer margin requirements and member accounts, failure to report reductions in licensee capital, failure to maintain minimum capital requirements, and conduct detrimental to the Exchange.<sup>58</sup>

The Division believes that the penalties imposed appear reasonable relative to the conduct being sanctioned. The penalties also appear sufficient to deter future similar violations.

#### **E. Conclusions and Recommendations**

Based upon its review, the Division found that the Exchange maintains an adequate disciplinary program. The Exchange's rules and disciplinary structure give the Exchange appropriate authority to discipline, suspend, or terminate the activities of members pursuant to clear and fair standards. During the target period, the Exchange issued complaints with reasonable promptness after cases were sent to the BCC, and moved with reasonable promptness after issuance of complaints to conclude the disciplinary process and impose sanctions. During the target period, the Exchange assessed \$44,000 in fines against five members and imposed

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<sup>58</sup> The remaining case involved a member who was fined \$5,000 and ordered to pay \$12,105 in restitution to the Exchange for destruction of Exchange property.

suspensions totaling five weeks for trade practice violations such as noncompetitive trading, prearranged trading, and trading against customer orders. In addition, three members were ordered to pay a total of \$26,931.10 in restitution to customers. The penalties imposed appear reasonable relative to the conduct being sanctioned.

Based on the foregoing, the Division has no recommendations at this time with respect to the Exchange's disciplinary program.

